

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Burden of Proof as to whether Individual Payments Constitute Kickbacks pursuant to 162(c)(1) and (c)(2).

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Product =

Individuals =

Perform Action =

Federal Law 1 =

Federal Law 2 =

Federal Law 3 =

State =

A =

B =

C =

D =

E =

F =

Date 1 =

Date 2 =

Date 3 =

Industry =

Title =

Name =

ISSUE

Whether an income tax deficiency, arising from disallowed expenses that are determined by the Commissioner to constitute kickbacks described in I.R.C. § 162(c)(1) and (c)(2), requires the Commissioner to prove by clear and convincing evidence that each payment is a kickback, or that only some of the payments are kickbacks, where § 162(c)(1) and (c)(2) place the burden of proof on the Commissioner to the same extent as under § 7454 (concerning the burden of proof when the issue relates to fraud).

CONCLUSION

The Commissioner is not required to prove by clear and convincing evidence that each payment is a kickback described in § 162(c)(1) and (c)(2). Proof by clear and convincing evidence that only some of the kickbacks are described in § 162(c)(1) and (c)(2) is sufficient for the Commissioner to meet the burden of proof imposed by these subsections. The Commissioner may then make determinations as to the related deficiencies, and these determinations are presumed to be correct; the taxpayer bears the burden to prove that the determinations are in error.

FACTS

Taxpayer engaged in the manufacture, promotion, and sale of Product. Taxpayer's managers allegedly encouraged sales representatives to persuade Individuals to Perform Action for Taxpayer's Product by taking the Individuals out for repeated dinners and paying the Individuals for speaker engagements. The sales representatives allegedly warned the Individuals that these benefits would not continue if they failed to Perform Action for Taxpayer's Product. Taxpayer deducted the dinner expenses as meals and entertainment expenses, while payments made to Individuals for speaker engagements were deducted as advertising expenses (collectively, "Expenses").

Taxpayer was criminally charged with Federal Law 1, and entered a guilty plea. Taxpayer agreed to pay a criminal fine in excess of \$A, forfeiture in the amount of \$B, and restitution to certain victims. Additionally, Taxpayer was sued civilly in a qui tam action under the Federal Law 2. The United States did not intervene, but moved to stay the civil proceedings in the District Court of State while a grand jury investigation was undertaken by the State AUSA. Both matters were resolved in Date 1 and in the civil settlement, Taxpayer agreed to pay the plaintiffs more than \$C, but made no admission of guilt. Taxpayer did not admit to the entirety of the facts as alleged by the government, but did admit that from Date 2 through Date 3, sales representatives took Individuals out for dinners that included little or no education and that certain speakers were paid fees to provide promotional presentations even though, in certain instances, they did not give a complete presentation or any presentation at all. In addition to the federal suits, Taxpayer was sued by some states individually, a few of its district managers pleaded guilty to Industry fraud, and the Title of the company, Name, was unsuccessfully criminally prosecuted for conspiracy to violate the Federal Law 3.

When the Commissioner analyzed Taxpayer's books and records, it was determined that the amount of Expenses was approximately \$D. Based on a sample of E line-items of Expenses, the Commissioner found that only F% of the meals and entertainment expenses paid to Individuals were acceptable as legitimate expenses, and none of the advertising expenses paid to Individuals were acceptable as legitimate expenses. The Commissioner issued notices of proposed adjustments, proposing to disallow the Expenses that were not considered legitimate expenses.

LAW AND ANALYSIS

Section 162(a) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 162(c)(1) disallows any deduction for any payment made to an official or employee of any government if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977. The burden of proof as to whether a payment constitutes an illegal bribe or kickback (or is unlawful under the

Foreign Corrupt Practices Act of 1977) shall be upon the Secretary to the same extent as he bears the burden of proof under § 7454 (concerning the burden of proof when the issue relates to fraud).

Section 162(c)(2) disallows any deduction for any payment made to any person if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States or any law of a State (but only if such state law is generally enforced). The burden of proof as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under § 7454 (concerning the burden of proof when the issue relates to fraud).

Section 7454(a) provides that in any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Secretary.

There is a presumption of correctness attached to any determination of deficiency made by the Commissioner. Rule 142(a), Tax Court Rules of Practice; Welch v. Helvering, 290 U.S. 111, 115 (1933); Neaderland v. Comm'r, 52 T.C. 532, 538 (1969). When the Commissioner disallows a deduction, the burden is generally on the taxpayer to prove to the Tax Court the merits of the deduction. Rule 142(a), Tax Court Rules of Practice; INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992); Nor-Cal Adjusters v. Comm'r, 503 F.2d 359, 361 (9th Cir. 1974). Deductions may be disallowed if they would frustrate sharply defined national or state policies proscribing particular types of conduct, such as where a taxpayer has violated a federal or state statute. Comm'r v. Heininger, 320 U.S. 467, 473 (1943). Some of these disallowances are codified in the Internal Revenue Code.

Section 162(c)(1) and (2) disallow deductions for certain payments that would otherwise be deductible under § 162(a), and place the burden of proving that a payment is one described in § 162(c)(1) or (2) on the Commissioner to the same extent as he or she bears the burden of proof under § 7454 (concerning the burden of proof when the issue relates to fraud). Section 7454(a) provides that for proceedings involving fraud with the intent to evade tax, the burden of proof with respect to that specific issue is on the Commissioner. This burden is to be carried by clear and convincing evidence. Rule 142(b), Tax Court Rules of Practice. The Commissioner may meet his burden by presenting several badges of fraud throughout the entire record. Hicks Co. v. Comm'r, 56 T.C. 982, 1019 (1971).

Although the burden of proving fraud falls upon the Commissioner, the burden of proving entitlement to deductions is with the taxpayer. Id. at 1031. Once the Commissioner proves fraud with clear and convincing evidence, the burden shifts to the taxpayer to rebut the Commissioner's deficiency determination on any items falling within the logical ambit of that fraud, and, further, such rebuttal must take the form of something more than bank statements, receipts, and cancelled checks, or cursory, unsubstantiated assertions of business need. See Neaderland at 538-541.

Courts generally presume that Congress is aware of the law pertinent to the legislation it enacts, particularly when the new legislation invokes and builds off of an existing framework. Internal Revenue Service v. Murphy, 892 F.3d 29, 35 (1st Cir. 2018) (quoting Goodyear Atomic Corp. v. Miller, 486 U.S. 174, 184-85 (1988)). When Congress obviously borrows words from another legal source, the words “bring[] the old soil with it.” Sekhar v. U.S., 570 U.S. 729, 733 (2013) (quoting Justice Frankfurter in Some Reflections on the Reading of Statutes, 47 Colum. L. Rev. 527, 537 (1947)). Here, in § 162(c)(1) and (c)(2), Congress directly references the fraud statute, so we must assume that Congress was aware of the law pertinent to the legislation—namely, that once the Commissioner meets his burden of proving the presence of fraud, he may make a determination regarding deficiencies coming within the logical ambit of that fraud, and those determinations are presumed to be correct. This is a straightforward result, and, absent the presence of any congressional intent to the contrary, we must generally apply these established principles regarding fraud and deficiency determinations to § 162(c)(1) and (2).

Thus, in the present case, similar to fraud cases, once the Commissioner proves that some of the Expenses are kickbacks described in § 162(c)(1) or (c)(2), he or she then separately determines the total deficiency in the income tax. This means that while the burden of proof falls to the Commissioner with respect to the issue of whether some of the Expenses are described in § 162(c)(1) or (c)(2), the Commissioner retains the presumption of correctness in regard to the determination of any deficiencies. The burden of proof regarding Taxpayer's deficiency does not shift to the Commissioner unless a separate provision shifts that burden. For example, § 7491(a) shifts the burden of proof as to all issues relevant to the amount of the taxpayer's liability if the taxpayer introduces credible evidence, substantiates items, maintains required records, and fully cooperates with the Commissioner's requests.

Here, the Commissioner is required to prove by clear and convincing evidence, by considering the entire record, that Taxpayer made some payments that are kickbacks described in § 162(c)(1) or (c)(2). Once the Commissioner has met this burden of proof, he or she may disallow Taxpayer's deductions for Expenses by making a determination of deficiency. This determination has a presumption of correctness. The Commissioner does not bear the burden of proving by clear and convincing evidence that each individual payment is a kickback described in § 162(c)(1) or (c)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-5100 if you have any further questions.